



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201143021**
Release Date: 10/28/2011
Date: August 1, 2011

Contact Person:
Identification Number:
Contact Number:
Employer Identification Number:
Tax Years:

501.12-03

Legend:

State =
U =
\$X =
\$Y =

Dear

We have considered your ruling request dated November 30, 2010, regarding the tax consequences relating to the proposed transactions described below.

You are exempt from federal income tax under section 501(c)(12) of the Internal Revenue Code (hereafter Code). You are a cooperative under the laws of State. Your members elect the board of directors on a one member, one vote basis.

You serve approximately U members to which you provide electrical energy services.

Pursuant to Article VII, Section 2 of your bylaws, your operations shall be conducted in a manner so that all patrons, except those excluded by contract, will furnish capital to you. "In order to induce patronage and to assure that the Cooperative will operate on a non-profit basis, the Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of electric energy in excess of operating costs and expenses properly chargeable against the furnishing of electric energy."

Further, your bylaws specify that you are obligated to pay credits to a capital account for each patron all such amounts in excess of operating costs and expenses. Your books and records are required to be set up in a manner so that at the end of each fiscal year, the amount of capital, if any, furnished by each patron is clearly reflected and credited in an appropriate record to the capital account of each patron. Each patron will be notified of the amount credited to his or her account at a reasonable time after the end of each fiscal year.

Your bylaws further state that if your board of trustees determines that your financial condition will not be impaired, the capital credited to patrons' accounts may be retired in full or in part. The board has discretion to determine the method, basis, priority, and order of retirement, if any, for any amounts furnished as capital.

As of December 31, 2009, you have allocated and have an unretired patronage capital of $\$x$ to your patrons, and had a total capitalization of $\$y$. Historically, you have retired the previously allocated patronage capital on a cycle of approximately 20 years, using the first-in, first-out redemption model.

You have stated that your sources of electric generation will change in the next decade. You also expect fossil fuels will become more difficult to use, and additional financial resources will be required to acquire or upgrade electric transmission assets. Seeking to strengthen your equity resources, you have proposed to retire the current patronage allocations to current, former and deceased patrons on an accelerated basis. This retirement would occur by a cash payment of the "present value" of the future capital credits payments. The proposed redemption program would be voluntary.

You have asserted that the proposed "equity patronage capital credit discounting" is beneficial. You stated that participation in the program would allow current and former members to receive the present value of the cash payments they would otherwise receive many years in the future. You have said that the difference between the face amount of the equity capital credit and the amount paid will be reserved as permanent equity, to be distributed only at your dissolution or liquidation.

You have represented that your board of trustees will adopt a formal policy stating that:

- The board of trustees, in its sole discretion, may establish an equity discounting program voluntary to all parties whereby all or a portion of existing allocated patronage capital may be paid in cash at present value to members/patrons, former members/patrons, and/or deceased member-patron's estates.
- The annual equity discount rate to be applied to determine present value of early redemption will be established by the board of trustees to equal the 20-year Treasury risk-free bond rate determined as of the first business day of the year in question plus a risk factor, unique to you, and determined by your board of trustees.
- In the sole discretion of your board of trustees, each member/patron, departing member/patron, former member/patron, and deceased member's estate may be given the option of receiving the present value of their cumulative allocated patronage capital or, in the board's discretion, a limited number of years or year.
- Members/patrons, former members/patrons, and members' estates will be given the option of participating in the present value discounting program. The board of trustees

may suspend the present value discounting program if in its sole judgment such action is in the best interest of the cooperative.

You have requested the following rulings:

- (1) Following the adoption by the members of your proposed policy to accommodate patronage credit discounting, you will be operating on a cooperative basis and will not jeopardize your tax-exempt status under section 501(c)(12)(A) of the Code.
- (2) Your proposed discounting of equity capital, as contemplated, is consistent with the requirements of Rev. Rul. 72-36, 1972-1 C.B. 151, and will not constitute a forfeiture of patronage capital.
- (3) The proposed methodology for determining the discount rate is consistent with the precepts of cooperative tax law, and is within the board of trustees' discretion.

LAW:

Section 501(c)(12) of the Code provides for the exemption from federal income tax of benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Rev. Rul. 72-36, 1972-1 C.B. 151, describes certain basic characteristics an organization must have in order to be a cooperative organization described in section 501(c)(12)(A) of the Code. These characteristics include the following: A cooperative must keep adequate records of each member's rights and interest in the assets of the organization. A cooperative must not retain more funds than it needs to meet current losses and expenses. The rights and interests of members in the organization's savings must be determined in proportion to their business with the organization. A member's rights and interests may not be forfeited upon the withdrawal or termination of membership. Upon dissolution, gains from the liquidation of assets should be distributed to all current and former members in proportion to the value or quantity of business that each did with the cooperative over the years.

Rev. Rul. 83-170, 1983-2 C.B. 97, describes a cooperative organization formed to provide cable television to its members. The revenue ruling states that the term "like organization," as used in section 501(c)(12) of the Code, is applicable to those mutual or cooperative organizations that are engaged in activities similar in nature to a public utility-type service. This ruling was cited affirmatively in Rev. Rul. 2002-54, 2002-37 I.R.B. 527 (Sept. 16, 2002) and Rev. Rul. 2002-55, 2002-37 I.R.B. 529 (Sept. 16, 2002). We have cited these three rulings to support the conclusion that providing electric services on a cooperative basis are public utility-type services, and thus qualify as "like organization" activities.

Rev. Rul. 2002-55, 2002-37 I.R.B. 529, 530, provides that in order to maintain tax exemption under section 501(c)(12), the cooperative must compute the 85 percent member income test in each taxable year. The test requires a cooperative to combine all sources of income not otherwise excludable under section 501(c)(12)(B) or (C) and calculate whether more than 15 percent of that income is derived from non-members. The cooperative has the burden of proof to establish that it satisfies the 85 percent member income test for each taxable year.

In Puget Sound Plywood v. Commissioner, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, the court stated that an organization must meet certain common law requirements in order to be a cooperative. These common law requirements include: democratic control of the organization by members, the organization operates at cost for the benefit of members, and the contributors of capital to the organization do not control or receive most of the pecuniary benefits of the organization's operations (i.e. subordination of capital).

DISCUSSION:

Redemption of Capital Credits at Discount

Section 501(c)(12) of the Code provides for the federal tax exemption of electric cooperatives, including other cooperative organizations not relevant here. While the term "cooperative" is not defined in section 501(c)(12) or the regulations thereunder, a cooperative has been traditionally and historically defined as a voluntary, membership business organization that is organized in response to the economic needs of and to perform services for its members, and not to realize monetary gains as a separate legal entity. A cooperative is organized and operated for the benefit of and is democratically controlled by its members. See Puget Sound Plywood v. Commissioner, 44 T.C. 305, 308 (1966), *acq.* 1966-1 C.B. 3. Hence, to qualify for exemption under section 501(c)(12), an organization must be a cooperative and organized and operated as such. Puget Sound Plywood, supra, describes the principles that are fundamental to the organization and operation of cooperatives. They are: (1) democratic control by the members, (2) operation at cost, and (3) subordination of capital. These principles apply to organizations described in section 501(c)(12).

Democratic control requires that the cooperative be governed by members and on a one-member, one-vote basis. Each member has a single vote regardless of the amount of business he or she does with the organization. The issue of democratic control is a question of fact.

Operation at cost requires that the cooperative's net earnings or savings derived from furnishing services in excess of costs and expenses be returned to its members in proportion to the amount of business conducted with them. This principle ensures that a cooperative's net savings from members are returned to members in proportion to the amount of business each transacts with the cooperative. A cooperative satisfies this requirement by making periodic allocations of patronage to members.

Subordination of capital has two requirements. First, control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remains in the hands of the members rather than with non-patron equity investors. Second, the returns on

equity investments must be limited. Hence, the net savings that accrue to the cooperative from the business activities it transacts with its members will largely inure to the benefit of those members rather than to its equity investors. The rationale for these limitations is to ensure that the cooperative remains faithful to its purpose—providing services at the lowest possible prices (or highest possible prices for a marketing cooperative) to its members and not to realize profits for capital. If it were otherwise, the emphasis then would likely be on protection of returns of equity capital rather than services to members, and this would destroy the basic purpose of cooperatives. See Puget Sound Plywood, supra. Thus, the redemption of capital credits at a discount rate cannot violate any of these cooperative principles in order for the organization to remain exempt under section 501(c)(12).

Rev. Rul. 72-36, supra, also describes additional requirements that are fundamental to the organization and operations of cooperatives described in section 501(c)(12). The revenue ruling requires that a member's rights and interest in the assets of a cooperative cannot be forfeited upon termination of membership. It also requires that upon dissolution, a cooperative must distribute any gains from the sales of its assets to those who were members during the period that the assets were owned.

Section 501(c)(12)(A) provides that a cooperative exempt under this Code section must derive 85 percent or more of its income from members for the sole purpose of meeting losses and expenses in order to qualify for and maintain tax exemption. The 85 percent member income test requires that 85 percent or more of the cooperative's income be derived from members and used to pay for services listed in section 501(c)(12). See also Rev. Rul. 2002-54, 2002-37 I.R.B. 527 and Rev. Rul. 2002-55, 2002-37 I.R.B. 529. In each particular tax year, the cooperative must combine all income received and calculate under this test. The cooperative is not tax-exempt under section 501(c)(12) of the Code if less than 85 percent of its income is derived from members and used to pay for services listed in section 501(c)(12). This private letter ruling does not address the issue of whether the redemption of capital credits counts as non-member income under the 85 percent member income test.

A fundamental tenet of cooperative operation is that the earnings of a cooperative are allocated and ultimately distributed to its members based on the amount of business (patronage) done with those members. The amount a cooperative member pays for the cooperative's services less the cost of providing such services is allocated to the member. Thus, the presumption is that the cooperative's services are provided at cost to the members. But it is impractical for such a cooperative to return immediately all the amounts or earnings to its members because the cooperative needs to have reserves in order to operate, meet unexpected expenses, or to expand. These amounts or earnings are held by the cooperative for a certain period of time as prescribed by cooperative bylaws and are allocated as capital credits to accounts kept for each member. These capital credits are returned to the members or former members when the cooperative redeems them (i.e., sends a check for the amount of the capital credits) at the end of the prescribed time.

Your bylaws and proposed board of trustees policy provide for the redemption of capital credits at a discount. The redemption will be at a discount, i.e., the capital credits are not paid on the face value of the accounts but at the present value at the time the redemption is made.

You will transfer the difference between the discounted amount and the original amount in the capital credit accounts to your net savings account. The redemption program will be voluntary to current or former members.

The primary issue raised by the operation of the redemption program is whether it violates any of the cooperative requirements described in Puget Sound Plywood, supra, and Rev. Rul. 72-36. The cooperative principle of democratic control by members is satisfied because the redemption of capital credits at discount will not affect member voting rights or governing rights. We also note that the cooperative (and its board of directors and management) has fiduciary duties to former members, and the former members can enforce their rights in the courts. See Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982). The cooperative principle of operating at cost is satisfied because the members' right to receive the excess (i.e. capital credits) over the cost of electricity service is also not adversely affected.

The cooperative principle of subordination of capital is satisfied because the proposed redemption program does not adversely affect the members' control and ownership of the cooperative assets. The cooperative requirement that there is no forfeiture of former members' rights to assets of the cooperative is not violated. Specifically, the redemption program permits members and former members to receive the present value of their capital credit accounts (i.e., patronage savings) at a date earlier than a 20-year holding period or cycle. The discount rate is in accordance with the prevailing market rate. Thus, redeeming the capital credits at a discount rate would not violate cooperative principles, and your tax-exempt status under section 501(c)(12)(A) would not be jeopardized, assuming you meet the 85 percent member income test.

You have said that the difference between the face amount of the equity capital credit and the amount paid would be reserved as permanent equity, to be distributed only at your dissolution or liquidation. The issue is whether this proposal violates cooperative principles.

This proposal does not violate the cooperative requirements of democratic control by members and non-forfeiture of a member's right to your assets because your trustees are subject to and responsive to the control of the members. We note that the members of the cooperative elect the trustees, and any members may submit resolutions to change the cooperative operations, subject to approval of the majority of members. Consequently, the transfer of the difference between the face amount of the equity capital credit and the amount paid to permanent equity, or net savings, under these circumstances does not violate any cooperative requirements and, therefore, your exempt status under section 501(c)(12) is not adversely affected, assuming you satisfy the 85 percent member income test for the particular tax year.

Accordingly, based on the foregoing facts and circumstances, we rule as follows:

- (1) Following the adoption by the members of your proposed policy to accommodate patronage credit discounting, you will be operating on a cooperative basis and will not jeopardize your tax-exempt status under section 501(c)(12)(A) of the Code.

- (2) Your proposed discounting of equity capital, as contemplated, is consistent with the requirements of Rev. Rul. 72-36, 1972-1 C.B. 151, and will not constitute a forfeiture of patronage capital.
- (3) The proposed methodology for determining the discount rate is consistent with the precepts of cooperative tax law, and is within the board of trustees' discretion.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Donna E Moore for

Mary J. Salins
Manager, Exempt Organizations
Technical Group 4

Enclosure
Notice 437